Policy to enhance market processes

5.18 The complexity of the technological and commercial decisions involved in interconnection are such that policy goals are best achieved by enhancing market processes. Private negotiations are the most realistic way to combine the motivation, timeliness, flexibility, and detailed information required to reach agreement, and to back up the process by market competition.

5.19 It is apparent, however, that disputes over access terms in a market environment are more or less inevitable in the telecommunications industry, given the continuing need for interconnection between complementary networks, the complexity of the issues involved in interconnection, and the imbalance of bargaining power in the presence of a dominant incumbent. Disputes such as between Clear and Telecom, and the many negotiations difficulties experienced by BellSouth in its dealings with Telecom are likely to be repeated time and again.

> Interconnection disputes in competitive telecommunications regimes are almost certainly a fact of life, at best capable of temporary resolution pending further technical or commercial change in a dynamic industry.[29]

5.20 It is possible that such disputes will become more frequent and more complex as further innovation takes place and more new services, with new and varied requirements placed on the incumbent network for access. Also the competitive consequences of interconnection may become more pressing as the structure of the industry becomes more interrelated with those of other neighbouring industries. This is likely to continue as long as there are significant imbalances in bargaining power.

5.21 Private negotiations and market forces are most effective in handling the issues involved in access, but there needs to be controls to offset the effect of incumbent market power. An appropriate policy vehicle is a dispute resolution process which can maximise the use of market negotiations and encourage the parties to seek a mutually acceptable outcome.

> Policy should be constructed to ensure that the technological path is as flexible as possible, that resources are channelled toward those institutions which consistently provide large social benefits, and that viable economic opportunities are available to those who push out the technological frontier.[30]

Policy framework

5.22 There is therefore a need to enhance and accelerate the development of new contractual arrangements to ensure the timely adoption of modern technology and the delivery of enhanced services. Changes to the existing regime should aim to support the operation of market forces in negotiating access, and correct for the imbalance in bargaining power between the incumbent and the entrant. These changes should be designed and expected to minimise the cost of distortions

29 Gatt (1995), p.18.
30 Rosenberg (1994), p.228.

created by the changes by emulating processes that would be likely to occur naturally were the telecommunications market truly competitive. They should also be designed and expected to reduce the transaction costs associated with the current regime.

5.23 There is tremendous potential for growth and increased economic and social welfare stemming from developments in the telecommunications sector. Achieving the benefits possible with an advanced network of networks will depend on the application of competition and innovation. BellSouth believes that policy needs to emphasise flexibility and efficient entry. This will make maximum use of market processes, provide the discipline of the market place and put primary reliance on private negotiations to determine interconnection agreements. It provides for multiple sources of innovation, the cornerstone of dynamic competition. This offers the best option for maximising welfare and achieving the objectives of productive, allocative and dynamic efficiency.

6. BELLSOUTH'S POSITION

Enhancement of market processes to maximise welfare

6.1 It has been clearly demonstrated that change to the current regime is required to achieve Government policy objectives of maximising the telecommunication sector's contribution to overall economic efficiency. The best approach is to provide mechanisms to enhance market processes and thereby promote market exchange and private contracting among industry participants.

6.2 The enhancement of market processes to maximise welfare should begin with the establishment of broad economic principles to guide commercial negotiations and a compulsory and time-bound arbitral process, supported by strengthened disclosure requirements:

- controls over conduct will create greater welfare than controls over ownership
- light-handed regulation which emphasises reliance on market processes will produce greater welfare than direct interventions
- reliance under the current regime on general competition law and existing disclosure requirements has been demonstrated to have failed to constrain anti-competitive behaviour by the dominant incumbent
- direct Government intervention in the market processes for access to complementary network services is inappropriate
- guiding principles will promote market exchange and private contracting among industry participants and increase the effectiveness of any dispute resolution process
- detailed industry-specific principles will not increase certainty and will not provide sufficient flexibility to accommodate an industry undergoing transformation through competition and innovation
- a compulsory time-bound two-part arbitral process represents the best option for dispute resolution where required
- strengthened disclosure will support market processes and enable redress where appropriate

6.3 The evaluation of the options for change needs to weigh the potential costs of any change against the undoubted benefits:

> ...any need for change...requires a careful consideration of various alternatives to the present regime in the light of the Government's objectives [of the]...[31]
>
> ...establishment, implementation and monitoring of legislative frameworks for the fair and efficient conduct of business and the operation of markets...[32]
>
> ...the selection of the preferred option will involve trading-off the risks of market failure against the risks of regulatory failure...[33]

6.4 There are two types of costs which must be weighed against the potential benefits from the introduction of new measures or the selection of a particular alternative:

- the transaction costs associated with the regime
- the costs for distortions created by the regime

6.5 In examining the potential options for policy enhancement at the broadest level, the options can be characterised by two dimensions:

- controls over ownership
- controls over conduct (pricing, terms and conditions, standards adoption/implementation, numbering administration, etc.)

6.6 There are very significant disadvantages to implementing competition policy through controls over ownership, particularly in such a potentially competitive and highly dynamic industry such as telecommunications. State-owned firms tend to be poor at maximising profits, controlling costs, meeting customers' needs adequately and making efficient investment decisions because of the distorting effects of the political process. Breaking up firms may forgo economies of scope and increase transaction costs because of the need for arm's-length dealings.

> In many cases these [undesirable] side effects [of state ownership] will be sufficiently large to rival the welfare loses from unregulated monopoly power.[34]

6.7 There are two dimensions which characterise the options for control over conduct:

- the scope and prescription of the constraints, if any
- the nature of the institution(s) through which these constraints are imposed

6.8 Under the current regime, the only effective constraints on the behaviour of the dominant incumbent is general competition law as invoked through the Courts. This

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31 Ministry of Commerce and Treasury, "Regulation of Access to Vertically-Integrated Natural Monopolies", Wellington, New Zealand, 15 August 1995, paragraph 13, page 3.

32 Ministry of Commerce and Treasury, "Regulation of Access to Vertically-Integrated Natural Monopolies", Wellington, New Zealand, 15 August 1995, paragraph 2, page 1.

33 Ministry of Commerce and Treasury, "Regulation of Access to Vertically-Integrated Natural Monopolies", Wellington, New Zealand, 15 August 1995, paragraph 177, page 45.

34 Ministry of Commerce and Treasury, "Regulation of Access to Vertically-Integrated Natural Monopolies", Wellington, New Zealand, 15 August 1995, paragraph 5, Appendix C, page 79.

light-handed approach presumes that it is preferable to create incentives for market participants to negotiate commercial solutions and, if necessary, have recourse to a dispute resolution process than it is for a regulatory body to intervene directly.

6.09 Light-handed regulation also recognises that in a competitive market information creates powerful incentives for action and attempts to create information flows in order to limit information asymmetries which might either frustrate direct negotiation or undermine the potential for obtaining legal remedies. It relies on the regime providing adequate remedies for dealing with the anti-competitive behaviour of dominant firms.[35]

6.10 This approach minimises the extent of intervention on the basis that:

> ... industry-specific regulation would involve high administrative costs to the Government (i.e., the taxation and compliance costs for the industry):
>
> - past experience had demonstrated that government regulatory bodies were not well placed to take decisions affecting commercial activities. Accordingly, there was a risk that regulator or highly prescriptive "rules" could introduce distortion into the market;
> - the presence of a regulator would reduce the incentive on companies to resolve commercial issues (such as interconnection) through direct negotiation. A regulatory body could be placed under increasing pressure to intervene.
> - this in turn could result in "regulatory creep" - rules tend to beget more rules.[36]

6.11 The Discussion Paper aptly characterises the manner in which light-handed regulation is intended to operate in telecommunications:

> [I]t was anticipated that parties desiring access...would negotiate their own terms and conditions, with, as a last resort, the threat of recourse to the courts and the application of the Commerce Act... (paragraph 127).

6.12 The advantages of an effective light-handed regulatory regime in telecommunications are clearly very large:

- the pace of innovation in telecommunications is very rapid and there are potentially very large gains from dynamic and allocative efficiency
- disputes are more or less inevitable and will become more frequent and more complex as a result of the transformation of the industry through competition and innovation
- in a level negotiating playing field, market participants are best able to contract over the terms and conditions, including pricing for complementary network services to achieve efficiency and maximise social welfare

35 John Belgrave, Secretary of Justice, "The Regulatory Environment", Roundtable with the Government of New Zealand, Wellington, New Zealand, 13-15 March 1995, page 47.

36 John Belgrave, Secretary of Justice, "The Regulatory Environment", Roundtable with the Government of New Zealand, Wellington, New Zealand, 13-15 March 1995, page 51.

- a light-handed regime minimises transaction costs and market distortions

6.13 Although the policy of light-handed regulation clearly represents the best option for the telecommunications industry, the need for enhancement of the regime has also been clearly demonstrated. The decision to rely on general competition law was made on the basis that:

> The Commerce Act was considered sufficiently robust to constrain anti-competitive behaviour by the dominant party. Recourse to the Courts would be available if companies failed to reach agreement through commercial negotiation.
>
> Telecom had provided public undertakings to the Government of its intention to provide interconnection on fair and reasonable terms;
>
> Telecom's proposed restructuring was considered to provide formal transparent, arms-length dealing between various company operations, which would reduce the company's ability to discriminate against competitors in interconnection arrangements; and
>
> the Government reserved the option of further regulation in the event that this was required. The threat of further regulation was seen as providing an incentive for the parties to resolve matters on a commercial basis [37]

6.14 Experience has shown, however, that recourse to litigation through the current regime is too slow, too costly and does not produce an outcome. It does not adequately restrain anti-competitive behaviour by the dominant party. Although recourse to the Courts is available, such recourse in and of itself may serve to delay competition and restrict its ambit or extent.

Courts

6.15 The Courts are inappropriate to act as the regulatory institution for an access regime. The Courts have shown themselves to be unwilling to impose the type of solution required to determine finally access disputes. As stated by Areeda[38]:

> No court should impose a duty to deal that it cannot explain or adequately and reasonably supervise. The problem should be deemed irremediable by antitrust law when compulsory access requires the court to assume the day-to-day controls characteristic of a regulatory agency.

6.16 Indeed, the problem faced by Courts in making access determinations is highlighted by the *Clear v Telecom* case. Throughout the litigation, the High Court, Court of Appeal and Privy Council made determinations concerning theoretical principles to apply in determining access. At no stage did any of the Courts embrace the prospect of making an actual order for access terms. Indeed, the difficulties of the Courts doing so were noted. In its overall assessment of the Baumol-Willig rule, the High Court stated that ((1992) 5 TCLR 166, 217) it was unable to determine whether or not Telecom was currently earning monopoly profits: "...we cannot take the

37 John Belgrave, Secretary of Justice, "The Regulatory Environment", Roundtable with the Government of New Zealand, Wellington, New Zealand, 13-15 March 1995, page 51.

38 Refer note 141 at page 90 of the Discussion Paper.

evidence further. This Court is not a regulatory agency". Later, in considering whether the margin offered to Clear would prove to be too small to permit it to earn a sufficient return, the Court commented ((1992) 5 TCLR 166, 217) that "that is not a prospect that this Court can monitor".

6.17 The unwillingness of Courts to make the types of order required for access disputes is unlikely to be overcome in the near term. The problem the Courts have is a traditional one. The Courts perceive their role as being to apply specific laws to specific facts giving a result that is certain and specific, and which can be framed within traditional legal remedies of damages and equitable orders such as injunctions. The difficulties involved in access disputes do not lend themselves to that form of solution.

6.18 In that case, the fundamental requirement to have a regulatory institution able and willing to impose an appropriate range of solutions to an access dispute will remove the Courts as an appropriate contender.

6.19 Telecom has not provided interconnection on fair and reasonable terms except under duress and when a great deal of pressure has been brought to bear. It is naive to expect such an undertaking to take precedence over profit maximisation.

6.20 Furthermore, Telecom has moved away from transparent arm's-length dealings between various company operations. There are no effective constraints on its ability to discriminate against competitors in interconnection arrangements, not least because of the options open to competitors.

6.21 The option of Part IV regulation has not proved a credible threat and has not provided sufficient incentive for the parties to resolve matters on a commercial basis. This policy is ineffective at present and likely to become less so with the changing political landscape. Furthermore, it appears inconsistent with the light-handed approach.

The communication of policy via detailed Government statements

6.22 Direct Government intervention in market exchange and private contracting or the dispute resolution process through communicating detailed statements of policy to the regulatory institution is inappropriate. Most importantly, the use of such powers undermines New Zealand's light-handed regulatory regime; and it does so in a manner which is highly vulnerable to influence and not subject to the same protections as formal legislative processes.

6.23 The essence of New Zealand's light-handed regulatory regime relies upon private negotiations between competitors subject to:

- the existing competition policy regime
- information disclosure regulations

- the threat of further regulation if market dominance is abused

- the provision of strong and personal intervention by Ministers and the Prime Minister to pressure the parties to arrive at a settlement

6.24 While an appropriate regime for access requires supplementary elements (as outlined above), nevertheless the regime which is adopted must be such that all Government intervention, such as the intervention which has recently characterised the present regime, should be eliminated.

6.25 The most important aspect of the light-handed regulatory regime is predictability concerning the relevant rules and principles which apply to determining access. Any ability to alter those rules undermines that predictability, and undermines confidence in the access regime. In addition, the "light-handed" approach puts primary reliance upon private negotiations. Government intervention cuts at the heart of this element of the regime.

6.26 The most disturbing aspect of Government intervention lies in its vulnerability to outside influence. This vulnerability is diminished if the Government is required to use parliamentary procedures before intervening in the access regime. Parliamentary procedures subject the Government to public scrutiny and accountability. However, the use of Government statements pursuant to a power such as section 26 of the Commerce Act is not subject to the same scrutiny nor accountability. The result is that Government can be subject to lobbying and pressure may be exerted for the Government to alter the rules midway through an access negotiation. This is a highly undesirable situation.

6.27 Furthermore, to the extent to which the Government sought to exercise its powers in a balanced and careful manner, it will necessitate submissions by all interested parties. The preparation and consideration of submissions involves considerable effort, cost and time.

6.28 BellSouth submits that once the improved access regime is in place, the Government should observe the outcome of the process before making any further changes. If further changes are shown to be necessary (which, in view of the current transitory phase of the telecommunications sector, is likely), the Government should implement the changes through normal legislative processes which are transparent, and subject to public scrutiny and accountability. At that time, the changes may involve prescribing additional principles for the determination of access terms and conditions. Experience with the improved access regime proposed by BellSouth will determine the necessity for any further changes.

The weight to be put on section 26-type policy statements

6.29 For the reasons outlined above, BellSouth submits that the regulatory institution should only be required to "have regard to" any section 26-type policy statements.

6.30 The degree of weight which the regulatory institution is required to put on the statement is likely to affect the style of policy statement made. If the regulatory institution is required to comply with the policy statement, there will be an increased temptation for the policy statement to be prescriptive in nature. In that way, the person making the policy statement is able to exercise greater control over the decision-making process.

6.31 If, on the other hand, the regulatory institution is only required to "have regard to" the policy statement, the policy statement is likely to be more general and directed toward policy in nature. This accords better with the New Zealand "light handed" regulatory approach, and the general approach to access advocated in these Submissions.

6.32 Again, such an approach preserves the independence of the private negotiations of the parties, and the ability of the regulatory institution to assess the competing approaches of the parties within the broader policy framework. While the regulatory institution may have regard to the policy statements made by the Government, it is better able to assess the competing interests involved in the access determination and give full effect to the proposed broad legislative principles.

6.33 Those broad principles are, by their nature, paramount in any access determination, and should override any inconsistent policy statement.

6.34 It is interesting to observe that the report by the Hilmer Committee recommended that, when declaring an essential facility under the proposed Australian access regime, the Minister making the declaration should also specify the pricing principles governing access to the facility and other policy considerations governing access. That recommendation was not adopted in the final access regime in Part IIIA of the Trade Practices Act. Instead, the Minister's discretion is limited to the decision whether or not to declare the essential facility for access. The legislative policy guidelines governing access are only invoked if the parties are unable to negotiate access and the matter comes before the Australian Competition and Consumer Commission for arbitration.

6.35 It has become clear that it was at best optimistic and at worst naive to expect that effective market processes for market exchange and private contracting would develop without some restraint on the conduct of the dominant incumbent. For most terms and conditions, the particular application of the Commerce Act has not been tested so the parties' legal rights are largely undefined. A dominant incumbent could seek to test the limits of what is lawful with respect to all of these terms and conditions, with consequent loss of welfare.

> Sustained litigation...will, over time, develop a body of precedents which defines with increasing degrees of precision, the terms and conditions that the [dominant incumbent] must offer... [and eventually] the regime will be defined sufficiently so that uncertainty will no longer hinder agreement...[T]his might take many years and cost many millions of dollars. In the meantime consumers are denied the benefits of competition.[39]

39 Ministry of Commerce and Treasury, "Regulation of Access to Vertically-Integrated Natural Monopolies", Wellington, New Zealand, 15 August 1995, paragraph 135, page 35.

Need for broad principles to enhance market processes

6.36 It is clear that some constraints on conduct of the dominant incumbent can yield significant net benefits and maximise welfare through competition and innovation. Broad, general economic principles should be established to enhance market processes and provide the effectiveness of any dispute resolution process:

- in the absence of any guidelines, too much reliance is placed on the dispute resolution process
- to the extent that principles clarify for industry participants what their rights are, this will limit reliance on the dispute resolution process and enhance market processes
- detailed industry-specific principles which are sufficiently flexible cannot be effectively articulated or enforced
- broad principles are consistent with maintaining the maximum flexibility for industry participants to reach their own agreement
- broad principles can be established through legislation, avoiding the danger of vulnerability to influence and lobbying inherent in more detailed principles

6.37 It is not possible to establish a set of detailed proscriptions and prescriptions which eliminate the possibility that the dominant incumbent can thwart efficient and innovative entry. The universe of potentially effective anti-competitive actions is simply too large. No legislation, even with supplemental pronouncements of Government policy, could possibly encompass this universe of potentially abusive conduct with respect to interconnection negotiations and contractual performance.

6.38 Furthermore, even if all possible abuses could be defined and rules specified, it is unlikely that the abuses could be effectively detected in light of the lack of experience with any industry-specific regulator or body or industry-specific judicial precedent and the information asymmetries present.

6.39 The principles to be applied must therefore respond to a variety of changing and complex situations. The market participants have the greatest opportunity and desire to identify all relevant principles which should be applied in negotiating an agreement. Government, its advisers and even industry economists are less likely to know the appropriate solution or principles to be applied to meet all situations.

6.40 Broad principles should be adopted for four key reasons:

- broad principles give maximum flexibility to market participants to reach their own agreements, without intervention

- the increase in certainty provided by detailed principles is likely to be limited because even detailed principles require application to facts and evidence and, in telecommunications, the facts will in themselves be complex

- if greater detail were sought to remove uncertainty, the risk of error or inappropriateness of the principles increases with a corresponding increase in the risk of regulatory failure

- broad principles clarify the essential aim of Government policy and provide a framework for negotiation, while maintaining flexibility to enable the optimum outcome

6.41 It is therefore of fundamental importance that these principles should be:

- consistent with the overriding principles in the Commerce Act

- broad and nonprescriptive

- suitable for application to disputes in the telecommunications industry

6.42 The aims of the broad principles should be limited to:

- clarifying the essential aims of Government policy

- providing a framework for negotiation

- maintaining flexibility to enable a superior outcome

Need for arbitral process to enhance market processes

6.43 Although establishing clear guiding principles will enhance market processes there will still, inevitably, be disputes. There is therefore a need for a dispute resolution process which is more timely and cost-effective than recourse to the Courts and which can produce an effective outcome.

6.44 There are four key factors which need to be taken into account in evaluating the options for a dispute resolution process:

- cost and delay of making decisions and taking action

- the range of solutions that can be imposed

- vulnerability to influence

- access to technical expertise

6.45 The best options for dispute resolution about the terms and conditions, including pricing, for access to complementary network services in the telecommunications industry is an arbitral process:

- general competition law invoked through the Courts has been demonstrated to have failed, taking too long, costing too much and failing to produce effective outcomes
- direct intervention by the Government under delegated statutory powers such as Part IV of the Commerce Act or through policy statements under section 26 has been demonstrated to be ineffective
- industry-specific regulatory authorities involve high costs, are vulnerable to regulatory creep, reduce the incentive on industry participants to resolve issues through market processes and introduce distortions into the market
- arbitration can be timely through being subject to explicit time constraints and hence cost-effective and can produce effective outcomes

Arbitrators and statutory regulatory agency

6.46 Both arbitrators and a statutory regulatory agency are able to impose the more flexible range of solutions required for access disputes.

6.47 The factors of cost and delay of making decisions and taking action, and of access to technical and economic expertise, can be made relatively neutral between arbitrators and a statutory regulatory agency.

6.48 With regard to cost, the major cost is the parties' own preparation and negotiation. The cost of the regulator may be much more than that of the arbitrator, but may in any case be relatively small in comparison to the costs incurred by the parties. In both situations, legislation can require that the costs of the arbitrator and the regulator be borne by the parties.

6.49 Delays can be overcome through the use of strictly regulated timetables. These can apply equally to arbitrators and to regulators.

6.50 With regard to access to technical and economic expertise, both arbitration and regulatory decision are flexible and should facilitate the use of expertise. In the case of arbitration, an arbitration panel may contain appropriate industry expertise, or appropriate experts can provide submissions. In the case of a regulator, expertise can be developed internally; but in addition external expertise can be sought.

6.51 A significant issue on the selection of arbitrators or regulators is vulnerability to outside influence. This factor is of considerable importance. It lies at the heart of confidence in the access regime, and therefore will influence strongly investment decisions.

6.52 Regulators are vulnerable to outside influence and should therefore be a less preferred alternative. This is due not only to a risk of capture of the regulator by industry concerns. The problem arises also from the concept of "regulatory responsibility". Regulators tend to be risk averse. Because they have a continuing existence, they are particularly concerned about criticisms of their decisions in the future. This concern is a factor which strongly influences decision making. In other words, in assessing alternative outcomes, a regulator is likely to consider which outcome has the least risk from the public perspective. Such considerations are a distraction from the merits of determining access terms. In addition, such considerations are particularly vulnerable to irrelevancies, for example the continuing viability of the incumbent firm in the public's view.

6.53 Arbitration can be subject to influence activities and rent-seeking but these shortcomings can be mitigated through careful design of the procedural and institutional rules. In addition, appropriate measures can provide arbitrators with access to specific economic and technical expertise, supported by powers to require the disclosure of information.

6.54 Arbitrators, on the other hand, are far less susceptible to these influences. First, and most importantly, arbitration permits the parties to the dispute to appoint their own arbitrator, or at the least the majority (say 2 out of 3) of the arbitrators who will determine the dispute. This gives the parties greater confidence in the independence of the outcome. Secondly, absence of continued existence provides a freedom in which to assess the merits of the access dispute and make a determination without regard to a perceived public perspective. Although not as independent as Courts, arbitration is in this context preferable as a means of dispute resolution.

6.55 It is possible to accelerate the definition of the appropriate constraints on conduct and thereby enhance market processes by making decisions precedential for subsequent tribunals, both arbitral and Courts. This will ensure that a sufficient body of precedents to provide enough transparency about the conduct of dominant incumbents is developed at a rate which is quick enough to realise the potential welfare gains from competition and innovation.

6.56 Arbitration is therefore preferable to both the use of the Courts or a dedicated regulatory body, each of which may be either ineffective in controlling the abuse of a dominant market position, or too directive in providing prescriptions for decisions which should properly be taken in the market place.

6.57 Using a dispute resolution mechanism rather than detailed ex ante direction allows market processes to be used via private contracting, as the primary method of determining interconnection terms. Using an arbitrator sets a timetable for the timely resolution of stalled private contracting.

6.58 In summary, arbitration is the most appropriate form of regulatory institution to determine access terms. Courts should be disregarded because of their unwillingness and inability to impose the types of solutions required in resolving

access disputes. A regulator should be disregarded due to the problems of outside influence and "regulatory responsibility".

6.59 The arbitration approach must be consistent with the particular characteristics of the telecommunications industry. There are two key developments which need to be taken into account in considering its likely future evolution:

- the potential through technological innovation for widespread horizontal competition for the provision of access to end users amongst network operators offering differentiated composite products and systems

- increasingly diverse and complex forms of complementary network services being exchanged amongst network operators to provide a wide and growing range of composite products and systems

6.60 There are two issues with very different characteristics which are the cause of dispute about the terms and conditions or pricing of complementary network services amongst network operators:

- the definition of the complementary network services or the property rights which are to be supplied

- the basis for pricing these complementary network services

6.61 The resolution of disputes over the definition of network services or property rights requires the parties to the dispute to converge on a solution which is acceptable to both. It has the characteristics of a co-operative game in which both parties are trying to work together to maximise the rents from the composite products or systems, by optimising the definition of the complementary network services. It will typically require both access to industry expertise and wide powers to require the disclosure of relevant information.

6.62 The resolution of disputes over pricing of complementary network services or property rights determines what proportion of these rents from composite products or systems are captured by each of the parties to the dispute. It has the characteristics of a non-co-operative game in which each party is trying to maximise the rent which it obtains at the expense of the other party. The best form of arbitration to resolve these disputes is sealed bid final offer arbitration, which avoids the chilling effect of conventional arbitration on private negotiations.

Need for strengthened mandatory disclosure by Telecom to enhance market processes

6.63 While guiding principles and an appropriate dispute resolution mechanism are necessary to enhance market processes, they are not sufficient. There is also a need for an adequate disclosure regime to overcome information asymmetries and provide the information that in a competitive market provide powerful incentives for

action. These information flows support market exchange and private contracting and ensure that industry participants have access to remedies where appropriate.

6.64 The relevant provisions of New Zealand's disclosure regulations require only the disclosure of accounting information and, more recently, the terms of actual transactions. The self-policing nature of the regulations provides significant opportunities for a dominant incumbent to game the disclosure requirements, and in particular the disclosure of the terms of relevant interconnection or analogous transactions.

6.65 In an investigation conducted by the Commerce Commission, the Commission concluded that:

> The information currently disclosed by Telecom under the Regulations does not provide significant assistance in removing any of the obstacles to the development of competition. It is not so much information that is the problem, but rather such matters as terms and conditions of supply, which in turn are heavily influenced by the structure of the industry.[40]

6.66 The Commission, in that same report, also concluded that:

> The kind of information that might support successful action under the Commerce Act would have to be more detailed and more specific than that provided under the Regulations. In other words, the information disclosed under the Regulations is too broad and general to be used in levering entry by means of legal proceedings. It is doubtful whether, in theory, information for such use could be regulated for, since every case turns so much on its own particular facts, and the telecommunications industry is one of the most dynamic there is.[41]

6.67 It is apparent from recent developments that the current disclosure requirements have added little to the process. BellSouth notes, for example, that all of the Courts which considered the Clear and Telecom dispute acknowledged the difficulty of proving monopoly profits. Officials, in the Discussion Paper, could only say that the available information is "consistent with the view that Telecom is benefiting from the absence of competition."[42]

40 Commerce Commission, "Telecommunications Industry Inquiry Report", Wellington, New Zealand, 23 June 1992, page 83.

41 Commerce Commission, "Telecommunications Industry Inquiry Report", Wellington, New Zealand, 23 June 1992, page 83.

42 Discussion Paper, appendix G, paragraph 24, page 109.

7. THE SOLUTION/A POLICY BLUEPRINT

Summary

7.1 In these Submissions, BellSouth has concentrated on the telecommunications industry in New Zealand. The issues which gave rise to the Discussion Paper arose principally in the telecommunications industry. For this reason, policy makers need first to devote their attention to appropriate enhancements to the current light-handed regime in relation to the telecommunications industry. Because the telecommunications industry is in a state of transition from a regulated to a competitive industry, it is likely that further enhancements to the light-handed regime will in due course be necessary. Today, however, the problems discussed in detail in the Discussion Paper and in these Submissions must be addressed now.

7.2 Three critical enhancements should be made to the light-handed regulatory regime to give effect to or support a more effective dispute resolution regime in the telecommunications industry. These enhancements are:

- first, new broad economic principles should be enacted to guide the arbitrators and the new arbitral regime to be brought into effect in respect of the telecommunications industry
- secondly, a new arbitral regime should be brought into effect in respect of the telecommunications industry
- thirdly, information disclosure by Telecom as the dominant incumbent should be made more relevant and useful for disciplining its behaviour and providing reliable information, especially about costs and their allocation to competitors and particular network services

7.3 The enhancement of new broad economic principles should be introduced by way of specific amendments to the Commerce Act.

7.4 The enhancement of a new arbitral regime should also be introduced by way of specific amendments to the Commerce Act.

7.5 The enhancement of more relevant information disclosure by Telecom as the dominant incumbent should be introduced by way of the regulation-making powers which currently exist under the Telecommunications Act.

7.6 In addition, policy makers should also review current mechanisms for achieving social policy objectives in the telecommunications industry in New Zealand with a view to enhancing the regime, as appropriate, as the industry inevitably changes in the future.

7.7 Policy makers also need to address the related multilateral issues of compatibility standards and numbering specific to telecommunications.

7.8 These enhancements will maximise welfare as a result of increased dynamic efficiency through competition and innovation in the telecommunications sector in New Zealand.

7.9 The remainder of this part of these Submissions describes each of the particular enhancements to the light-handed regulatory regime in the telecommunications industry in New Zealand.

Broad economic principles

7.10 The first enhancement to the light-handed regime should be the enactment in the Commerce Act of broad and non-prescriptive economic principles to govern the determination of access terms.

Paragraph 195 principles

7.11 There is little doubt that at least two of the three principles set out in paragraph 195 of the Discussion Paper[43] will promote economic efficiency in a manner that is timely, certain and predictable. In particular, the broad principles so set out have the dual role of:

- preserving or facilitating competition in the related market (principle (a))
- promoting efficiency in the supply of the monopoly facility (principle (c))

7.12 Those principles, whilst based on section 73 of the Commerce Act, differ from that section in an important aspect. Section 73 of the Commerce Act focuses solely on the "controlled service". In order to facilitate market processes, these principles should extend to the related and any other market, in line with the language of Section 36 which is focused on control of the conduct of dominant firms. They should also recognize that the network characteristics of the telecommunications industry means that issues will arise even where no element is a monopoly, and reference should be made to the relevant *services*, rather than the *monopoly facility*.

7.13 The principle of safeguarding consumer interests is not a necessary addition to the principles. It can be assumed that if the access determination promotes efficiency in the monopoly facility, and preserves competition in related markets, consumer interests will be safeguarded as a necessary consequence. This is the foundation of the light-handed regulatory regime. Indeed, it is difficult to see what more is added by the consumer interest principle.

7.14 The inclusion of such a principle could well be counter-productive in that it may well necessitate evidence and debate in the context of an arbitration which, because of the subjective and amorphous nature of the principle, is unlikely to be determinative. The objective stated in this principle in any event will be met if the other principles suggested are included and applied.

43 (a) the extent to which competition is lessened or likely to be limited in the relevant market;
(b) the necessity or desirability of safeguarding the interests of consumers; and
(c) the promotion of efficiency in the production and supply or acquisition of the controlled service.

Promotion of competition and innovation

7.15 A principle of promoting competition and innovation should, however, also be included as one of the broad legislative economic principles. Competition and innovation will best deliver the overall policy objective of maximising the telecommunication sector's contribution to overall economic growth through promotion of economic efficiency.

7.16 Competition and innovation lead to the joint objectives of growth and economic efficiency. The implication is that a key policy aim should be to foster an environment that promotes this interaction of competition and innovation. Competition and innovation work hand in hand. Competition is the motivation for innovation and innovation is the most effective form of competition. This is Schumpeter's "perennial gale of creative destruction".[44]

7.17 Without competition, the dominant incumbent has reduced incentives to innovate. Innovation is one of the main means an entrant has to compete for markets; it may be the only way open to overturn an entrenched monopoly position. Similarly, competition forces firms to seek new ways to compete, the most effective way in the long run being via new services.

7.18 This "interwoven" mode of innovation and competition is based on entry. Only entry can provide sufficient variety of sources of innovation and technology from inside and outside the industry; the volume of resources to investing and introducing a full range of services; and the high powered incentives to compete by innovation. In other words, the incumbent cannot do it all.

7.19 There are many reasons to believe that dynamic and static efficiencies are lower in an industry structure and in the presence of a competition law which together do not allow market processes to promote market exchange and private contracting among industry participants. There is less competition to drive down prices and to encourage innovation. If the incumbent is the primary source of innovation, there is likely to be lower volume of innovation, and this may be biased towards the existing technologies rather than introducing new market-oriented innovations and services.

7.20 Innovation may come from a variety of sources, is usually unpredictable in its nature and impact, and may develop in unforeseen ways. Thus any principles must have the flexibility to allow this development without trying to force innovation in a given direction.

7.21 Occasionally, there may need to be trade-offs between static and dynamic efficiency. However, in the long term, dynamic efficiencies are much the more important determinant of economic performance, and the principles should recognise this.

7.22 The broad principle of promoting the combination of competition and innovation should be expressed in a new principle as follows:

> supporting the combination of competition and innovation to their mutual benefit and to encourage greater dynamic efficiency with, if there is a trade-off, precedence over short-term static efficiency gains.

44 Schumpeter, 1943, page 82; see also Rosenberg, 1994, page 51.

Broad economic principles which should be adopted

7.23 While agreeing with the thrust of the broad principles set out in the Discussion Paper, BellSouth believes that the expression of those principles can be improved. In particular, principle (a), which states "the extent to which competition is lessened or likely to be limited in the relevant market", could be expressed more directly. The policy objectives with regard to the related market referred to in principle (a) are dual:

- to ensure that efficient new entry is not prevented or restricted by the access terms and conditions including pricing
- to ensure that competition in that or any other market is not prevented, restricted, delayed or lessened by the access terms and conditions

7.24 Accordingly, principle (a) could be better expressed in a new principle as follows:

> *ensuring that efficient entry and competition in that or any other market is not prevented, restricted, delayed or lessened*

7.25 Also, principle (c), which states "the promotion of efficiency in the production and supply or acquisition of the controlled service" should also be better expressed in a new principle as follows:

> promoting efficiency including dynamic, allocative and productive efficiency in the production and supply or acquisition of the relevant services

Necessity for additional principles

7.26 Assuming the adoption of the above-mentioned broad principles, the next important question is whether any additional principles should be adopted. There is a wide variety of principles which could be stated, and which may be regarded as broad principles. Generally, those principles can be categorised as follows:

- principles which define more closely access pricing rules (for example, reciprocity, non-discrimination and unbundling)
- principles which define more closely the basis on which access to services should be provided (for example, interface definition and measurability)
- principles which seek to protect further the interests of the owner of the facility (for example, the cost of access and requirements to extend or increase capacity of the facility)
- principles which seek to protect the interests of third parties to the facility (for example, the protection of third parties who have pre-existing rights to use the facility)
- principles which seek to protect the broader public interest (for example, safety)

7.27 Subject to the broad principle of the promotion of the interaction of competition and innovation, there are several good reasons why there is little need to add to the broad principles referred to above:

- it is undesirable to limit the type of broad pricing principle which can be agreed through market exchange and private contracting
- it is undesirable to limit the basis on which access to services can be provided
- it is unnecessary to provide additional protection to the supplier of the service
- it is not clear whether or not additional broad principles are needed to protect third parties' interests
- it is unnecessary to include a broad principle relating to the public interest

7.28 It is undesirable to limit the type of access pricing principle which can be agreed or determined through market exchange and private contracting. In particular, the broad principles which are chosen must be drafted carefully on the premise that their application in the course of private negotiations and, if necessary, arbitration in the telecommunications sector, should generally lead to the application of the access pricing principles described in Appendix B of these Submissions. Even so, the parties should be free, in their private negotiations, to agree prices and access pricing principles which may in individual circumstances differ form the prices and principles which would otherwise be agreed or apply (or be determined or applied by the arbitrators) if those specific access pricing principles so described were applied.

7.29 It is also undesirable for similar reasons to limit the basis upon which access to services should be provided. In principle, the parties themselves should have full freedom to define the terms and conditions of access to network services bought and sold by each other. However, this will only produce efficient outcomes and allow competition to develop if two vital obstructions today to the free definition of service definitions are removed. These obstructions are compatibility standards and numbering. These two issues are considered in Appendices G and H to these Submissions.

7.30 The interests of the supplier of the service need little additional protection under the access regime. The facility provider controls a monopoly. Promotion of efficiency does not mean that the legitimate business interests of the facility provider will be overridden, as it is fundamental to efficiency to recognise the provider's investment in the facility and the costs of access.

7.31 It is unnecessary to include a broad principle relating to the public interest. As mentioned earlier, the public interest is protected by the promotion of competition and innovation in a related market and the promotion of efficiency in the monopoly facility. The latter efficiency principle should have due regard to other factors such as safety, thereby ensuring that the wider public interest is protected by the access regime.

7.32 It is not clear as to whether or not additional broad principles are necessary to protect the interests of third parties to the facility. It can be expected that those interests would be taken into account by any institution required to resolve disputes between the parties. Nevertheless, if there is any doubt that this is the case, an additional broad principle could be added as follows:

> safeguarding the interests of third persons currently using the facility or having contractual rights to use the facility

7.33 In conclusion, the following broad legislative principles should be adopted. The objective of Government policy which firms should have regard to in market exchange and private contracting, and which any tribunal should be required to comply with, are to maximize welfare by:

- ensuring that efficient entry and competition in that or any other market are not prevented, delayed, restricted or lessened
- promoting efficiency, including dynamic, allocative and productive efficiency, in the production and supply or acquisition of the relevant services
- supporting the combination of competition and innovation to their mutual benefit and hence encouraging greater dynamic efficiency with, if there is a trade-off, precedence over short-term static efficiency gains

7.34 In addition, the following principle may be included:

> safeguarding the interests of third persons currently using the facility or having contractual rights to use the facility

Regulatory institution - the arbitral regime

Relevant factors

7.35 The second enhancement to the light-handed regime which is required is the enactment in the Commerce Act of an arbitral regime to determine disputes concerning access terms.

7.36 There are four key factors that determine the appropriate regulatory institution to determine disputes concerning access terms:

- cost and delay of making decisions and taking action
- the range of solutions that can be imposed
- vulnerability to influence
- access to technical expertise

7.37 A number of those factors can be made neutral between regulatory institutions without too much difficulty. For example, the precedent value of decisions can be increased by a legislative principle requiring an arbitrator or regulator to have regard to previous

decisions. This requires access decisions to be made public, but this is contemplated in Appendix A of the Discussion Paper in any event. Also, rules for determining standing and admissibility of evidence can be enshrined in legislation without difficulty. Such legislation can either increase flexibility in the court system, or introduce greater rigour for proceedings of an arbitrator or a regulator.

7.38 The factors of precedent value and rules for determining standing and admissibility of evidence have limited significance in the selection of the most appropriate regulatory institution for an access regime.

7.39 On the other hand, certain factors are endemic to the regulatory institution and are difficult to change. Perhaps the most important of those factors is the range of solutions that can be imposed.

7.40 The object of access is to form a commercial agreement between two parties, the dominant incumbent and the entrant in a related market. The commercial agreement will contain specific terms and conditions under which access can take place and the price to be paid for a variety of components and products made available to facilitate access. Access or interconnect agreements are relatively sophisticated commercial arrangements. In the event of a dispute about access terms, the regulatory institution must finally determine the appropriate access agreement. An institution which is unable or unwilling to make this form of order is unsuitable for determining disputes.

The Appendix A arbitration process

Appropriateness of compulsory arbitration

7.41 Compulsory arbitration as a method of resolving disputes concerning access prices and terms and conditions should therefore be introduced as an amendment to the Commerce Act.

7.42 The arbitration process of the type set out in Appendix A to the Discussion Paper generally would be effective in ensuring that access is provided in a manner that is timely, certain and predictable.

7.43 Nevertheless, there are various aspects of the proposed arbitration process which require further consideration. Those aspects are:

- selection of appropriate arbitrators
- the procedure to apply for the arbitration
- time limit for rendition of arbitral award
- rights of appeal
- joinder of parties and consolidation of proceedings
- type of award, in particular final offer arbitration

- costs

Selection of arbitrators

7.44 The prime considerations for the selection of arbitrators should be:

- expertise
- neutrality

7.45 Expertise comprises knowledge and experience in one or more of the following:

- law and arbitration
- industry economics
- industry expertise

7.46 The requirement of neutrality requires that:

- arbitrators be independent of each party and have no actual or perceived conflict of interest
- arbitrators not be seen as government regulators

7.47 The Discussion Paper[45] proposes that the Government would establish a panel of arbitrators with a cross section of expertise. In the event of a dispute over access, three arbitrators would be selected from the panel in accordance with the procedures set out in the Discussion Paper.

7.48 The need to establish a panel of arbitrators which is compulsory to the parties is doubtful. Limiting the field in this way runs the risk that appropriate persons with expertise would be excluded from acting as arbitrators. In particular, such an approach restricts the freedom of the parties themselves to agree on appropriate arbitrators to resolve the dispute.

7.49 Furthermore, establishing a panel of arbitrators creates the risk that the arbitrators will behave more like regulators than arbitrators. In other words, there is a risk that the arbitrators will perceive their role as fulfilling a government regulatory function. This may give rise to the concerns about decision making by regulators; in particular, the concern of capture and "regulatory responsibility".

7.50 It may also be difficult to achieve a panel of arbitrators which will comprise a sufficient cross section of skills to deal with access disputes. Indeed, often the most skilled experts are otherwise fully employed, and may be reluctant to be appointed to the panel of arbitrators. Consequently, the panel may be "second best", and the best expertise not utilised as a result.

45 Paragraph 11 of Appendix A to the Discussion Paper.

7.51 This does not preclude the establishment of an arbitration panel which is not compulsory. The establishment of such a panel may be helpful to parties in dispute who could have access to it on request.

7.52 For these reasons, the parties should be free to select their own arbitrator for dispute resolution. In establishing a tribunal, each party should be requested to nominate an arbitrator. The third arbitrator should be appointed by agreement of the two "party" arbitrators. If those arbitrators are unable to agree within a defined time (say, two weeks), an appointment should be made by a third person. The third person should be independent of the parties and should not be seen as a government regulator. One solution would be for the appointment to be made by the President of the Arbitrators' Institute of New Zealand.

7.53 In making the appointment, the President should have regard to the need to have both economic and legal expertise on the tribunal and the appointments made by the parties. If neither party has nominated a lawyer, the appointing authority should be required to appoint a lawyer.

7.54 The third ("non-party") arbitrator should act as an arbitrator - not an umpire - so that decisions of the arbitrators will either be unanimous or by majority.

Procedure

7.55 Subject to any agreement of the parties, the arbitrators should determine the procedure to be followed in the arbitration. In particular, the arbitrators should determine:

- what documents and written submissions are to be lodged
- how evidence will be presented
- whether a formal hearing or hearings should be held

7.56 It is also important to specify that:

- arbitrators are not bound by the rules of evidence
- parties may be represented by any person whether legally qualified or not
- arbitrators may appoint an expert or experts to assist them
- arbitrators may require the disclosure of information from parties
- arbitrators may issue an interim award or awards
- the third person appointed by the arbitrators will act as an arbitrator and not an umpire
- decisions of the arbitrators will be by unanimous or majority decision

Time limit for rendition of award

7.57 The arbitration procedure should be subject to a strict time limit for the rendition of an arbitral award.

7.58 A significant defect in the procedure set out in Appendix A to the Discussion Paper is the discretion given to the arbitrators to determine the timetable for the arbitration[46]. It is recognised that arbitration is a flexible process and arbitrators require flexibility in establishing arbitration procedures to meet the circumstances of the dispute. Nevertheless, it is in the public interest, as well as the private interest of the party seeking access, to ensure that there is a prescribed time limit on the rendition of the arbitral award. Otherwise, arbitration runs the risk of delay and frustration which is often inherent in court proceedings.

7.59 The time limit for the rendition of the award could be imposed in a number of ways. One method would be as follows:

- the initial arbitration would be subject to a strict time limit, such as six months
- the arbitration tribunal would have power to extend that period by an additional two months
- further extensions would only be permitted with the consent of both parties

7.60 An alternative method would be as follows:

- the initial arbitration would be subject to a strict time limit, such as six months
- the initial period could only be extended by the tribunal up to a maximum period of nine months, but during this period the tribunal must permit interim access

7.61 The proposal of six months is realistic. It is now common in commercial litigation for Australian Courts to impose strict timetables on parties to achieve speedy resolution of matters and commercial litigants have become accustomed to the management of their cases in this manner. This is particularly true of trade practices litigation in the Australian Federal Court. For example, in the recent takeover battle involving Coles Myer Ltd, Rank Commercial Ltd and Foodland Associated Ltd (which was injuncted by the Australian Trade Practices Commission), the Federal Court ordered a full trial in a period of less than three months. The Court emphasised the importance and feasibility of conducting trade practices disputes in a speedy manner. As it turned out, the bidding company, Rank Commercial, abandoned the bid and the proceeding ceased.

7.62 All commercial operations have the resources and ability to deal with access issues in a speedy manner, if required by legal process. Accordingly, it is vital for the arbitration process to have a prescribed time limit to achieve this result.

46 See paragraph 13(e) of Appendix A to the Discussion Paper.